Brazil: Critical IMF Negotiations [redacted] 25X1

Brazil's financial rescue package, hastily put together by the IMF and foreign banks in December, has stalled. Since April, the liquidity position has weakened considerably because of shortfalls in export earnings and the failure of foreign banks to provide expected amounts of short-term financing, thus forcing a run up of arrears. Brazil's cash-flow problem grew acute in June when more than $1 billion in IMF and foreign bank loan disbursements due to Brazil on 31 May were postponed because Brazil failed to meet the terms of its agreement with the IMF. To deal with this unanticipated foreign exchange deficiency, Brasilia is resorting so far to stopgap measures until it is able to resolve its differences with the IMF. [redacted] 25X1

Although we believe Brazil will ultimately reconcile differences with the IMF, the negotiations will be difficult. The IMF, supported by foreign creditor banks, is insisting that Brasilia adopt much tougher austerity measures than those implemented thus far. President Figueiredo, however, wants to avoid harsh steps that could provoke social unrest during the ongoing process of political liberalization. If a new agreement cannot be worked out soon, Brazil will have little choice but to declare at least a temporary moratorium on its debt servicing. [redacted] 25X1

Problems With the IMF

Brazil's IMF stabilization program was in trouble almost from the beginning because of unrealistic goals, the unwillingness of banks to fulfill financial pledges, and a lack of government aggressiveness in pushing austerity. By February, it became obvious that Brazil's current account deficit could not be squeezed even close to the $7 billion goal because of the slow world recovery and overvalued cruzeiro. To get the program back on track, the government carried out a large cruzeiro devaluation that month. This action boosted exports but fueled inflationary pressures. Accelerating inflation—to well over 100 percent—automatically pushed public-sector spending higher via the indexation system, eroding Brazil's ability to stay within IMF limits. Meanwhile, the reluctance of West European and US regional banks to restore interbank credit lines was largely to blame for Brazil's international reserve deterioration and an accumulation of payments arrearages. [redacted] 25X1

Brasilia subsequently demonstrated reluctance to tighten fiscal and monetary policies to deal with resurgent inflation. In early May, the IMF suspected that Brazil had fallen appreciably short on its commitments. Later in the month, a technical team found that Brasilia failed to meet major first-quarter performance targets—particularly public-sector spending and borrowing, domestic credit, and international reserves. On the basis of its findings, the IMF judged that Brazil did not qualify for a second loan installment scheduled for the end of the month. [redacted] 25X1

The IMF's decision to suspend further loan payments to Brazil intensified the country's cash-flow problem. Not only did the Fund defer payment of its $410 million installment but foreign banks postponed a planned 1 June transfer of $640 million in medium-term commercial loans tied to the IMF agreement. Brazil has been able temporarily to absorb this loss of funds by rolling over payments on bridge loans due to the Bank for International Settlements and other banks. [redacted]

Since May, banker confidence in Brazil's ability and determination to manage its economy has dwindled. This has led to some erosion in short-term financing support. [redacted]

Renegotiations Under Way

With its loans cut, Brasilia recognized the need to implement some midcourse corrections. In preparation for an impending visit by an IMF negotiating team, the government's National Monetary Council on 9 June announced part of a new austerity package designed to raise government revenues and reduce public-sector spending. Among the measures disclosed were trimmed subsidies for agriculture and exports, higher prices for petroleum products, and increased taxes in the financial sector. The package, however, omitted Planning Minister Delfim's proposals for heavy cuts in state enterprise budgets and changes in Brazil's wage and price indexation system. [redacted]

Since arriving in Brazil on 11 June, the IMF team has stressed that Brazil must take stronger steps. Particularly, the Brazilian Government has been urged to slash public-sector spending. The team is also pressing for deindexing wages. [redacted]

Some progress has been made in the talks. Brasilia reportedly pledged a quicker phaseout of subsidies for wheat and sugar. The government cut public enterprise investment and made some cuts in public employee benefits and cost-of-living adjustments. [redacted]

While the IMF talks have proceeded, a new 14-member bank advisory committee has been laying the groundwork for steps to overcome Brazil's growing financial problems. [redacted] Brazil's major creditors have indicated that they probably will arrange a new $3 billion medium-term commercial loan to see the country through the end of 1983. A loan of this size [redacted] would compensate Brazil for shortfalls both in interbank deposits and in export earnings. The committee reportedly is prepared to begin consideration of Brazil's 1984 financing and debt rescheduling needs. [redacted] concrete actions must await IMF approval of a new Brazilian austerity program. [redacted]

Obstacles to Settlement

We believe major differences between Brazil and the IMF remain:

- The announced public spending cuts appear inadequate for Brazil to reach its public deficit target under the original IMF agreement. Recent large protest demonstrations and strike threats are likely to discourage Brasilia from making sharp cuts in public employee compensation, and the new investment controls will have little immediate impact on spending.

- The other sticking point in the negotiations is Brazil's complex indexing system. Fearful of the social consequences of dismantling the system, Brasilia has proposed manipulating the index to provide less than 100-percent linkage. The IMF, however, wants a break in the automatic wage-price adjustment mechanism. [redacted]

We believe that Brazil will reach a settlement with the IMF, but negotiations will most likely be difficult. Both Brasilia and the IMF have considerable stakes in a successful outcome and both want to avoid the consequences of a collapse. Still, the Brazilian Government has become worried about the political fallout of the deepening recession and is resisting tougher steps.

The Alternative to an IMF Accord

If the IMF renegotations are not settled by the end of July, the Brazilian Government probably will declare a limited debt moratorium. By this time, foreign payments arrears very likely will have shot up sharply, perhaps to more than $2 billion. Moreover, growing uncertainty and diminishing confidence would prompt bankers to withdraw more of their short-term trade financing and interbank deposit support, further aggravating Brazil's desperate foreign exchange reserve position.

Brasilia has been devising a contingency moratorium plan. Such an action probably would be applied only to principal payments and would be intended only for a short period of time. We believe that Brazil would hope that this type of a moratorium would provide opportunities for a new debt rescheduling plan—perhaps with substantial extensions of repayments terms and a reduction of interest rates.

Economic Performance Scenarios for the Rest of the Year

The direction that Brasilia chooses and foreign banker reactions will influence the depth of the country's recession. A decision by the government to stay with an IMF program and accede to the required conditions should net Brazil several billion dollars of additional foreign funds to support crucial import and investment activities. By contrast, if the government opts for a moratorium, no net inflows of foreign private loans would be forthcoming until a new financial package is arranged. The Brazilian Government undoubtedly will balance these considerations against its own political exigencies.

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The IMF Route. A revised stabilization agreement would not only free disbursement of withheld IMF and bank funds but would clear the way for Brazil to solicit new funds. Despite sharp import cuts, we estimate that Brazil would require at least an additional $2.5 billion in new money to cover its projected $7 billion current account deficit. Exports almost certainly will not attain Brasilia's original projected level of $23 billion because of slumping demand for its manufactures and raw materials such as iron ore. By putting its IMF program back on track, we believe creditor banks will raise another large loan to enable Brazil to fill its financing gap. A few large money center banks are recommending Brasilia seek $3-3.5 billion in new funds, but the cautious positions of a number of European and small US regional banks could reduce this amount.

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Continuing foreign exchange constraints and more austerity will lead to as much as a 5-percent decline in Brazil's GDP this year. Brasilia will have to continue squeezing imports through the remainder

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Brazil: Estimated Balance of Payments

	1982	1983 With IMF Agreement	1983 With Moratorium [a]
Current account balance	−14.5	−7.5	−6.0
Trade balance	0.8	5.5	7.0
Exports	20.2	21.5	20.0
Imports	19.4	16.0	13.0
Net service balance	−15.3	−13.0	−13.0
Interest payments	11.0	9.0	9.0
Debt repayments	20.8	22.2	18.6
Long-term maturities	7.8	7.2	3.6
Short-term maturities	13.0	15.0	15.0
Gross foreign exchange requirements	**35.3**	**29.7**	**24.6**
Financed by:			
Net direct investment	1.0	0.5	0.4
Official and supplier credits	5.2	4.0	3.0
Loans	27.0	27.8	23.8
Bridge operations	4.0	−3.6	−2.5 [b]
Short-term rollovers	10.0	15.0	15.0
Short-term borrowings	0.5	1.0	1.5
Long-term credits	12.5	15.4 [c]	9.8 [d]
Other	2.0	−2.6	−2.6

[a] Assumes Brazil declares a moratorium on amortization payments at the end of July.
[b] Assumes Brazil suspends repayment of bridge loans to foreign banks.
[c] Includes $2.5 billion from the IMF and an anticipated new $2.0 billion foreign bank loan.
[d] Excludes not only new loan but also currently deferred IMF and foreign bank payments on existing loans.

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of the year, forcing manufacturers to scale back production because of inadequate supplies of critical imported industrial materials. Furthermore, large cuts in state enterprise spending and continuing high real interest rates will assure declining investment activity for some months to come. Falling national output will probably boost unemployment rates close to double digits and heighten the risk of more wildcat strikes and cost-of-living demonstrations. 25X1

The Moratorium Route. Brazil's choice of a debt moratorium would very likely entail a freeze of short-term funds—including trade financing and interbank deposits—and a temporary deferral of amortization payments on medium- and long-term debt. Although a few large US money center banks might favor a moratorium of this type, we believe most banks would discontinue new lending activity until new austerity measures and debt rescheduling agreements can be arranged. 25X1

Denied access to its principal source of funds through yearend, Brazil, we believe, would have to slash imports by 40 percent in the second half. Sharply reduced availability of imported oil and raw materials would cause industrial and commercial output to plummet, and GDP could drop more than 10 percent for the year. Commodity shortages would very likely send inflation rates into the 150- to 200-percent range. Unemployment rates would climb—probably to the flashpoint for major social and political turmoil. The government's ability to deal with the resulting unrest could be sorely strained, and further movement toward political liberalization could be threatened. 25X1

Implications of a Moratorium

A decision to break off talks with the IMF and to temporarily suspend amortization payments to foreign banks would most likely be accompanied by a shakeup within President Figueiredo's three-man economic policy team. [redacted] 25X1 [redacted] 25X1 foreign banks have lost considerable confidence in the economic management abilities of Planning Minister Delfim and Finance Minister Galveas. Central Bank President Langoni also is vulnerable because of his past staunch defense of IMF austerity policies. [redacted] 25X1 We believe that even a limited moratorium would imply past economic policy failures and would likely augur the emergence of a new economic team. [redacted] 25X1

The successors to Delfim and other economic policymakers would face two unattractive policy options. They could—as we believe likely—seek a compromise with the IMF and a return to the suspended stabilization program. Brasilia would have to push harder to achieve important economic adjustments than it has up to now. The political price that the ruling government party would have to pay could be heavy. Alternatively, Brasilia's preoccupation with social discontent during the early weeks of a moratorium could lead Brazil's new economic leaders to adopt more growth-oriented policies. Such policies probably would exacerbate existing distortions in the economy, drive up inflation rates substantially, and enlarge the already major role of the public sector. [redacted] 25X1

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